

Chapter 6

BASIC TAXATION OF CAPITAL AND BUSINESS INCOME

I. Summary

The Treasury Department proposals for fundamental reform of the taxation of capital and business income are described in this chapter. Reforms directed at specific industries and at tax shelters are covered in chapter 7.

General reforms of three basic types are proposed. First, in order to measure real economic income more accurately, the Treasury Department proposes that inflation adjustments be made in the calculation of depreciation allowances, capital gains, the cost of goods sold from inventories, and interest income and expense. This will eliminate the need for the current arbitrary ad hoc adjustments for inflation incorporated in the investment tax credit, the accelerated write-off of depreciable property, and the partial exclusion of long-term capital gains.

Second, the Treasury Department proposes that current incentives for retirement savings be expanded by increasing the limits on contributions to individual retirement accounts (IRAs) and extending the availability of IRAs to spouses not employed in the marketplace. Also, the treatment of all tax-favored retirement plans will be rationalized by subjecting all pre-retirement distributions to uniform rules and simplifying the contribution limits applied to various plans.

Third, the Treasury Department proposes that corporations and partnerships be taxed in more nearly the same way by granting corporations a partial deduction for dividends paid and by taxing certain partnerships as corporations.

II. Lower Corporate Tax Rates

The Treasury Department's proposals to define the corporate tax base more comprehensively and eliminate most tax credits would allow the corporate tax rate to be reduced to 33 percent. All corporate income, except income of S corporations, which is accorded pass-through treatment, will be subject to this single rate. With a flat corporate rate only 2 percentage points below the proposed top individual rate, the personal holding company tax can be repealed. The current preferential rates for small corporations will be unnecessary once the corporate tax rate is reduced, especially since the reform package will substantially improve the competitiveness of small businesses.

III. Taxing Real Economic Income

The U.S. tax law takes a schizophrenic view toward the taxation of business income. On the one hand, some forms of income are treated quite favorably. Capital gains are taxed only when they are realized, 60 percent of long-term gains are excluded from the tax base, and gains on appreciated property transferred at death escape tax completely. On the other hand, nominal gains are subject to tax without an adjustment for inflation. Whether, on balance, real capital gains are taxed more or less heavily than ordinary real income depends on complicated interactions between the rate of inflation, the rate of appreciation, and the holding period of the particular asset.

Much the same is true of income from depreciable assets. On the one hand, the investment tax credit (ITC) lowers equipment costs, and asset lives under the Accelerated Cost Recovery System (ACRS) are shorter than economic lives. On the other hand, depreciation allowances are based on historic costs without adjustment for inflation.

The combination of the ITC and ACRS may be more or less generous than real economic depreciation, depending on the particular asset and the rate of inflation. At current rates of inflation, the ITC and ACRS generally provide capital recovery allowances that exceed the present value of the real economic depreciation which is required for the accurate measurement of income. Indeed, for short-lived machinery and equipment, the present value of capital recovery allowances under ACRS and the ITC is roughly equivalent to expensing (and in some instances is even more favorable); that is, at current inflation rates, there is no tax on (or even a subsidy to) the income earned by such assets.

The present tax treatment of depreciable assets is inappropriate in the context of an income tax. It gives rise to a form of tax arbitrage; taxpayers can borrow, receive a full deduction for interest paid, and invest in assets where the return is not fully subject to income tax. (Lenders are generally in lower rate brackets than borrowers, due to the "clientelee effect;" that is, high-bracket taxpayers tend to be borrowers while low-bracket taxpayers tend to be lenders under a progressive income tax). Moreover, capital recovery allowances under ACRS and the ITC are "front-loaded," in that they greatly exceed the value of economic depreciation in the early years of an investment; this feature has been an important contributing factor to both the stockpiling of unused tax deductions and credits by some firms and the recent dramatic growth of tax shelters.

The tax treatment of inventories is also rather schizophrenic. Firms are allowed to use last-in, first-out (LIFO) accounting, which provides an approximate adjustment for inflation in the calculation of goods sold from inventory. However, due to the "LIFO conformity requirement," firms using LIFO for tax purposes must use the same accounting method for financial reporting purposes. This requirement discourages the adoption of LIFO, since many firms apparently think

that the use of LIFO for financial reports would put them at a competitive disadvantage in attracting investment funds relative to firms that report profits using first-in, first-out (FIFO) accounting.

The Treasury Department proposes that the taxation and measurement of capital income be rationalized. The most critical element of a rational system is the accurate measurement of real economic income in an inflationary environment. To this end, the present system, with its ad hoc adjustments for inflation, such as the partial exclusion of long-term capital gains and the combination of accelerated depreciation and the ITC, will be replaced with explicit inflation adjustments for the basis used in calculating both depreciation allowances and capital gains. Since depreciation will no longer need to be accelerated to compensate for the effects of inflation, ACRS will be replaced with economic depreciation. With taxation based on real capital gains and real economic depreciation, the partial exclusion of long-term capital gains and the investment tax credit will be repealed. To prevent inflation-induced tax discrimination against industries that invest heavily in inventories, the availability of LIFO inventory accounting will be expanded by eliminating the LIFO conformity requirement. Indexed first-in, first-out (FIFO) accounting, a more accurate method of accounting for the effects of inflation on the cost of goods sold from inventory, will be made available, but not required.

Allowing inflation adjustment for capital gains, depreciation, and inventories, without also adjusting interest income and expense, would be neither fair nor neutral. Nominal interest rates include an inflationary component which merely compensates the lender for the reduction in real value of principal resulting from inflation. Without indexing of interest, the income of lenders would be overstated, since they would continue to pay tax on the inflationary component of nominal interest that represents a return of capital, rather than real income. Conversely, the income of borrowers would be understated, since they would continue to take a deduction for the full amount of nominal interest paid including the inflationary component. This problem is particularly serious in an indexed world, since borrowers can invest in assets that benefit from inflation adjustment. In order to mitigate this problem of income measurement, the Treasury Department proposes that both interest expense (in excess of home mortgage interest plus \$5,000) and interest income be indexed for inflation, using the fractional exclusion method described below.

The proposed inflation adjustments will assure that taxpayers no longer pay tax on fictitious income from capital that merely reflects inflation; similarly interest deductions subject to the inflation adjustment will not be bloated by inflation premiums that do not represent real costs. For all adjustments, inflation will be measured by the change in the consumer price index for urban households (CPI-U); this index was chosen because it is familiar, readily available, and not subject to revision after it is published.

Allowing deductions for real economic depreciation and for the real cost of goods sold from inventories will improve the measurement of real income from business and capital. This, in turn, will increase tax equity and reduce tax-induced distortions in investment decisions. Many tax shelters are motivated by the combination of the up-front benefits of the investment tax credit and accelerated depreciation, the deductibility of nominal interest expense, and the preferential taxation of capital gains. Eliminating the ITC, indexing capital gains and taxing them as ordinary income, indexing interest expense, and gearing depreciation allowances for tax purposes more clearly to real economic depreciation will substantially reduce the benefits of investments in tax shelters. These measures will simultaneously increase the return to investments in industries that are currently disadvantaged by the tax system, including established industries with disproportionately large inventories or use of structures, as well as new, emerging industries such as those in the "high technology" area. Also, decreased use of tax shelters and the taxation of real corporate income will increase the perceived fairness of the income tax.

Inflation adjustment inherently involves complexity. Nonetheless, the Treasury Department believes that the economic advantages flowing from improvement in the measurement of real economic income during inflation more than offset the cost of increased complexity.

Indexing for inflation may give the impression that inflation is expected; indeed, some will argue that indexation weakens the private sector's resistance to inflation and therefore makes inflation more likely. The proposal for inflation adjustment should not be interpreted as a prediction that high inflation will resume. Prudent monetary policy would keep the inflation rate at the low level forecast by the Administration. Nor does inflation adjustment in the measurement of taxable income necessarily produce higher inflation. While indexing may reduce private resistance to inflation, it also eliminates the possibility of using inflation to raise taxes on real capital and business income.

Inflation adjustment is best seen as insurance against inflation for taxpayers and for the nation. High rates of inflation are not expected, but if they occur, Americans will not be forced, as they were during the 1970s, to suffer the inequities, distortions, and adverse impacts on capital formation that result from an unindexed tax system. Increased complexity is part of the price for that insurance.

A. Capital Gains

Capital gains on assets held for at least a prescribed period have long benefitted from preferential tax treatment. In particular, tax on accrued gains is postponed until gains are realized (usually through the sale of an asset), 60 percent of long-term nominal capital gains are excluded from the tax base, and gains on assets transferred at death completely escape income taxation. Nevertheless, during an inflationary period, capital gains may be subject to very high

effective tax rates because purely inflationary gains are included in the tax base; for example, during the high inflation years of the 1970s, effective tax rates on real capital gains frequently exceeded 100 percent, despite the 50 percent exclusion then in force. Similarly, despite the current 60 percent exclusion, real capital gains can be taxed at rates greater than those applied to ordinary income if the rate of inflation is sufficiently high. Moreover, under current law the effective tax rate on capital gains varies tremendously with the inflation rate.

In addition to compensating poorly for the effects of inflation, the current exclusion of 60 percent of long-term nominal capital gains effectively overtaxes taxpayers who have little or no investment success (since sufficiently small nominal gains are actually capital losses), and it undertaxes very successful investors (since the exclusion overcompensates for inflation for sufficiently large gains). This treatment is clearly inequitable.

The Treasury Department proposes that the tax treatment of capital gains be rationalized by making a precise adjustment for inflation through indexing the basis of capital assets for the inflation which has occurred since purchase of the asset or January 1, 1965, whichever is later. Since roughly 84 percent of the inflation during the postwar period has occurred since 1964, this will result in nearly complete inflation adjustment for almost all assets, while limiting the size of the table of inflation adjustment factors. Inflation-adjusted gains will be taxed as ordinary income at the proposed reduced individual rates; that is, the current 60 percent exclusion would be repealed.

In order to limit the transition problems associated with an unexpected change to the new system of taxing indexed capital gains as ordinary income, indexing of assets held as of the date of enactment will be delayed until 1989 and the current approach to taxing capital gains on those assets will be maintained through 1988. (That is, nominal gains will be taxed at a maximum rate of roughly 20 percent through 1988). Assets acquired after enactment, however, will be subject to indexing under the new tax rules as of the date of acquisition.

The existing preferential tax treatment of capital gains has been justified by the need to avoid taxing fictitious gains that merely reflect inflation, to stimulate investments in risky undertakings, to avoid applying highly progressive rates to gains bunched in one year, and to prevent investors from having investments in appreciated assets "locked in" by the tax system. The effects of the Treasury Department proposal in each of these problem areas will be examined in turn.

Inflation adjustment. The current exclusion of 60 percent of long-term capital gains is a very rough way of allowing for the effects of inflation. At high rates of inflation it is inadequate, but at low rates it is too generous.

In contrast with the current ad hoc adjustment for inflation, the proposed adjustment will be precise. At current rates of inflation (4.0 percent in 1983 and 1984), most taxpayers will be subject to roughly the same effective tax rate on long-term capital gains as under current law (preferential taxation of nominal capital gains at a maximum 20 percent rate). At rates of inflation experienced in recent years (an average annual rate of 7.9 percent between 1972 and 1982), the proposal will significantly reduce the effective tax rate on real capital gains. This is shown by Table 6-1, which provides maximum effective tax rates on real capital gains under current law for various combinations of inflation rates, rates of real appreciation, and holding periods. In each part of the table, effective rates below the broken line are higher than the 35 percent maximum rate on ordinary income proposed in this Report; only the current law effective rates above the broken line are less than this proposed rate.

Only for assets held for very long periods is current law likely to be preferred to the proposed 35 percent rate on real gains. If, for example, the real rate of appreciation is 4 percent and the inflation rate is 4 percent or more, a tax rate of 20 percent applied to nominal gains produces an effective rate in excess of 35 percent, except for assets held 10 years or longer. The story is only slightly different if the real rate of appreciation is a rather high 7 percent per year. At an inflation rate of 5 to 7 percent, current law produces effective tax rates on gains on assets held for less than 5 years that do not differ greatly from 35 percent.

Although current inflation rates are relatively low, the "insurance" benefits of a tax system which guarantees an explicit inflation adjustment should not be minimized. For example, inflation averaged 7 percent per year between 1971 and 1975. Over that period, nominal capital gains on sales of corporate stock totaled \$24.6 billion. However, once adjusted for inflation, these sales actually represented a loss of \$0.4 billion. Similarly, reported nominal gains on sales of real estate over the same period totaled \$13.2 billion, while the inflation-adjusted gain was only \$5.3 billion. The 50 percent exclusion rate in effect during that period clearly was far from adequate in terms of allowing for inflation. Indeed, no exclusion rate can make up for a negative real rate of appreciation. By comparison, under the Treasury Department proposal, the inflationary component of nominal capital gains will always be excluded from the tax base. The associated reduction in variation in effective tax rates caused by inflation should stimulate investment in capital assets. Thus, the Treasury Department believes that with inflation indexing, reduced tax rates, and a rate structure with only a few wide income brackets there is no need for preferential tax treatment of realized capital gains, beyond that provided by the substantial benefits of deferral of tax until gains are realized and the exemption of gains on assets transferred at death.

Effect on risk-taking. The effect of capital gains taxation on private risk-taking in the economy is of critical importance. Venture capital and associated high-technology industries seem particularly

Table 6-1

Effective Tax Rates on Realized Capital Gains
Under Current Law for 50 Percent Bracket Taxpayer
With Different Real Rate of Return Assumptions

Inflation Rate (Percent)	: Nominal : Appreciation : Rate : (Percent)	: Holding Period in Years : : : : : : : : 1 : 3 : 5 : 10 : 20 : :					
		1	3	5	10	20	:

CONSTANT 4 PERCENT REAL RATE OF RETURN

0	4	20.0	20.0	20.0	20.0	20.0
2	6	30.0	29.4	28.9	27.7	25.6
3	7	35.0	34.0	33.1	31.0	27.8
4	8	40.0	38.5	37.1	34.1	29.6
6	10	50.0	47.3	44.9	39.7	32.5
8	12	60.0	55.9	52.0	44.5	34.7
10	14	70.0	64.0	58.8	48.6	36.3
12	16	80.0	71.9	65.1	52.1	37.6

CONSTANT 7 PERCENT REAL RATE OF RETURN

0	7	20.0	20.0	20.0	20.0	20.0
2	9	25.7	25.2	24.9	23.8	22.4
4	11	31.4	30.3	29.1	27.1	24.1
5	12	34.3	32.8	31.4	28.5	24.7
6	13	37.1	35.2	33.4	29.9	25.3
7	14	40.0	37.5	35.4	31.1	25.8
8	15	42.9	39.9	37.3	32.2	26.3
10	17	48.6	44.5	41.0	34.4	27.0
12	19	54.3	48.9	44.4	36.3	27.6

Note: Figures in bold face type below the broken line indicate combinations of inflation rates and holding periods for which the proposed treatment is more favorable than current law.

sensitive to changes in effective tax rates. The supply of venture capital largely dried up during the 1970s when effective tax rates on real gains were high due to inflation and other provisions in the Code, but revived dramatically after the 1978 and 1981 tax changes reduced the maximum tax rate on realized long-term capital gains to 20 percent and inflation rates fell significantly from earlier levels.

In light of this experience, the likely effects of the proposed treatment of capital gains on the supply of venture capital and "high technology" industries are of particular interest. Taxing real (indexed) capital gains at a maximum ordinary income rate of 35 percent will result in a greater tax burden on the most successful investments made by venture capitalists. If one assumes sufficiently high rates of return and moderate rates of inflation, indexing for inflation, even over the approximately 7 to 10-year life of the average venture capital investment, will not be as generous as the 60 percent exclusion. Some argue that this treatment, even if desirable on equity grounds, will unduly inhibit investment in the high technology industries typically funded by venture capitalists.

The basic principle underlying the Treasury Department proposals -- that all income should be taxed equally -- suggests that the taxation of real capital gains as ordinary income is the appropriate policy for all industries, including the venture capital industry. Perhaps more importantly, the Treasury Department believes the proposed treatment of capital gains is unlikely to have significantly negative effects on these industries. Several arguments can be made to support this position. More accurate measurement of economic losses and reduced variation in effective tax rates resulting from inflation will stimulate all investment, including investment in the venture capital and high technology industries.

Moreover, a maximum marginal tax rate of 35 percent on indexed capital gains will produce effective rates that are not substantially above those experienced during the last two venture capital booms. (Rates of 25 percent during the 1960s and 28 percent from 1978-81 on nominal gains were actually higher effective rates due to inflation.) Such an environment should be favorable to risky venture capital investments.

Also, the increase in saving stimulated by reductions in individual marginal rates and expansion of IRAs, as well as the elimination of many industry-specific tax preferences coupled with the enactment of measures to reduce the advantages of investment in unproductive tax shelters, should increase the supply of capital available to high technology industries. Finally, roughly one-half of the funds committed to so-called venture capital firms come from tax-exempt entities, such as pension funds, endowments, and foundations, or from foreign investors. To the extent that these are equity funds, their supply will not be affected by changes in the tax treatment of capital gains. For these reasons, the Treasury Department believes

that taxation of indexed capital gains as ordinary income is unlikely to have significantly negative effects on the supply of venture capital to high-technology industries.

Other issues. Implementation of the Treasury Department proposal will have little effect on effective capital gains tax rates at moderate rates of inflation, and will significantly reduce effective rates at high rates of inflation. While the proposed treatment will have little effect on lock-in and bunching problems at moderate rates of inflation, it will mitigate them considerably at high rates of inflation, when they are most serious.

Simplification. Taxing real (inflation-adjusted) capital gains as ordinary income will complicate the tax system in some respects but, on balance, should result in simplification. Adjusting the basis of assets for inflation will result in some complexity, but taxpayers will not need to perform overly complex calculations since they will derive the applicable adjustment from a table. On the other hand, significant simplification will result from eliminating the distinction between capital gains and ordinary income, including repeal of recapture rules as well as the extremely complicated collapsible partnership and corporation provisions. Real gains from the sale of most assets will simply be taxed in the same way as all other income. Many elaborate schemes designed to obtain capital gains treatment for ordinary income will lose much of their attraction; as a result, fewer resources will be wasted in tax planning activities as well as in auditing returns with questionable conversion schemes. Once the proposed new tax treatment of business income is fully phased-in and all (or most) grandfathered assets are out of the system, the corporate minimum tax could be repealed.

B. Capital Consumption Allowances

The investment tax credit (ITC) and the accelerated cost recovery system (ACRS) were introduced during a period of rapid inflation to stimulate investment by preventing capital consumption allowances based on historical cost from being eroded by inflation. Without explicit indexing of depreciation allowances, the effects of rapid inflation on the return to investment in depreciable assets are so deleterious that something like ACRS and the ITC was essential to prevent confiscatory taxation of income from capital. Under the Treasury Department proposal, ad hoc accelerated capital recovery allowances like the combination of ITC and ACRS would be unnecessary; explicit indexing for inflation would ensure that future depreciation allowances would maintain their real value, regardless of the rate of inflation.

Since current rates of inflation are significantly lower than those prevailing when the ITC and ACRS were enacted, current law allows investment in depreciable assets to be recovered far more rapidly than under a neutral system of income taxation. Table 6-2 indicates the effective tax rates applied to income from various types

of assets under current law; the figures apply to equity-financed investments by corporate taxpayers subject to the 46 percent statutory rate, for inflation rates between 0 and 10 percent.

As shown dramatically in Table 6-2, the combination of ACRS and the ITC results in a system where, at the rates of inflation covered by the table, effective tax rates are lower than statutory rates but vary, often significantly, with the rate of inflation. For example, at an inflation rate of 5 percent, the effective tax rates paid by a taxpayer subject to a 46 percent statutory rate vary from -8 percent for equipment with a 3 year ACRS life to 40 percent for a structure with an 18 year ACRS life. (A negative tax rate is the equivalent of the Federal Government paying a business to buy the asset and earn income tax-free.) Effective tax rates are lower, (that is, even more negative), for short-lived assets with lower inflation rates. At higher inflation rates such as those prevailing at the time of enactment of ACRS, effective tax rates are somewhat closer to the statutory tax rate, especially for longer-lived asset. (See Table 6-2 for effective tax rates under an inflation rate of 10 percent.) The current system is obviously deeply flawed, since effective tax rates vary tremendously among asset types and with inflation. Moreover, by reducing effective tax rates below the statutory rate, the tax system favors investment in depreciable assets such as equipment and real estate over investments in labor and in inventories. This results in effective tax rates which vary widely among industries, as demonstrated in Table 6-3.

Nevertheless, returning to the non-indexed economic depreciation of the pre-ACRS period is clearly unacceptable; the high effective tax rates on business plant and equipment during the 1970s that resulted from the failure to allow tax-free recovery of the real cost of capital reduced investment and economic growth. Instead, the Treasury Department proposes that the investment tax credit be repealed, that the basis of depreciable assets be indexed for inflation, and that depreciation allowances for tax purposes be set to approximate real economic depreciation. A combination of indexing for inflation and economic depreciation -- a Real Cost Recovery System, or RCRS -- will retain, and even reduce, the effective tax rates for depreciable assets that are present in the ACRS system, reduce the uncertainty about future changes in effective tax rates that occur without indexed depreciation, and eliminate the current tax bias toward investment in depreciable assets.

The enactment of the Treasury Department proposal will have four very significant advantages over current law. First, the benefits of economic neutrality will be realized. Effective tax rates on depreciable assets will no longer vary according to asset life, as depreciation allowances will be approximately equal to the real economic depreciation of assets. Effective tax rates will also no longer vary across industries, as investment in all industries will face the same reduced corporate tax rate. As a result of tax treatment which is economically neutral, the allocation of the nation's scarce resources will be greatly improved.

Table 6-2

Effective Tax Rates on Equity-Financed Investments
with Various Rates of Inflation for a 46 Percent Taxpayer
Under Current Law ^{1/}

Asset class (years)	:	Inflation	Rate	(percent)
	:	0	5	10
3		-90	-8	22
5	Equipment	-51	-3	19
10		-5	20	32
15		9	35	45
18	Structures	28	40	45

^{1/} Assumptions: Real return after tax is 4 percent. The investment credit rate selected is the maximum allowable (6 percent on 3-year equipment and 10 percent on 5-, 10-, and 15-year equipment). Effective tax rates are the difference between the real before tax rate of return and the real after-tax rate of return divided by the before-tax rate of return.

Table 6-3

Effective Tax Rates on Equity Financed Investments in Equipment
and Structures by Industry with Various Rates of Inflation
for a 46 Percent Taxpayer Under Current Law

Industry	Inflation Rate (percent)	
	5	10
Agriculture	29	37
Mining	13	31
Logging	21	34
Wood products and furniture	28	38
Glass, cement and clay	20	31
Primary metals	16	28
Fabricated metals	28	38
Machinery and instruments	26	36
Electrical equipment	26	38
Motor vehicles	8	26
Transportation equipment	25	36
Food	25	35
Tobacco	18	30
Textiles	19	32
Apparel	28	38
Pulp and paper	12	26
Printing and publishing	22	34
Chemicals	19	32
Petroleum refining	12	26
Rubber	18	30
Leather	30	40
Transport services	9	26
Utilities	28	38
Communications	19	33
Service and trade	31	40

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Second, effective tax rates will no longer vary with the rate of inflation. Businesses planning investments will be assured that the value of future depreciation allowances will be automatically corrected for inflation; they will not have to depend on Congress for periodic ad hoc and imperfect adjustments in tax laws to accomplish this correction. The reduced uncertainty implied by enactment of the Treasury Department proposals should stimulate investment in all industries.

Third, capital recovery allowances will no longer be "front-loaded," or accelerated to the early years of the productive life of an investment. Because the advantages of the ITC and ACRS are front-loaded, these provisions are of relatively little value to new and rapidly growing firms or to firms in ailing industries, neither of which can fully utilize their benefits. The Treasury Department proposal would thus eliminate a tax penalty faced by new firms and would eliminate incentives for tax-motivated mergers. The result will be increased competitiveness and more incentive for innovation. Also, elimination of front-loading of tax benefits will reduce the advantages of tax shelters, many of which are abusive and create severe administrative burdens for the Internal Revenue Service.

Fourth, these reforms will broaden the corporate tax base, just as many reforms in the individual income taxation area broaden the individual tax base. The most important effect in the corporate area is that the maximum corporate tax rate will be reduced from 46 to 33 percent.

The new method for taxing business income proposed by the Treasury Department is best appraised by examining the combined tax burden at the corporate and individual levels, in order to reflect the benefits of the dividend-paid deduction. Table 6-4 presents combined effective tax rates for a variety of alternative ways of taxing income from depreciable assets and inventories. Under the Treasury Department proposal the combined effective tax rate is 44 percent, regardless of the rate of inflation. This is substantially more generous than the tax treatment under ACRS, without the ITC or dividend relief, which at an inflation rate of 5 percent, produces a combined effective tax rate of about 58 percent. At an inflation rate of 10 percent the Treasury Department proposal is more generous than ACRS, even with the ITC. Even at an inflation rate of 5 percent, it is more favorable than current law, except for investment in equipment.

Table 6-5 shows effective tax rates at only the corporate level. The Treasury Department proposal for a Real Cost Recovery System produces approximately the same effective tax rate on income from all forms of investment, while the alternative approaches produce widely varying effective rates that depend on the rate of inflation.

C. Inventories

Under current law, taxpayers are allowed two basic options in calculating the cost of goods sold from inventories. They can either

Table 6-4

Effective Corporate and Personal Income Tax Rates on Equity Financed Investments
—Returns to Capital Distributed Equally Between Dividends and Capital Gains—^{1/}

	<u>All Capital</u> ^{2/}	<u>Equipment and Structures</u>	<u>Equipment</u>	<u>Structures</u>	<u>Inventories</u> ^{3/}
Pre-1981 law ^{4/}					
at 10 percent inflation	63	63	51	66	61
ACRS ^{5/}					
With investment tax credit					
at 10 percent inflation	58	57	43	61	61
at 5 percent inflation	53	50	26	56	61
Without investment tax credit					
at 5 percent inflation	58	57	57	56	61
Real economic depreciation ^{6/}					
Without dividend relief ^{7/}	49	49	49	49	49
With dividend relief ^{8/}	44	44	44	44	44

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- ^{1/} Assumes a 4 percent real return after corporate tax. Assumes two-thirds of capital gains deferred indefinitely, and the remaining third taxed at the same effective tax rate (35%) on real gain in order to eliminate any possible bias against current law, because the effective tax rate on capital gains under current law depends on the interrelationship between inflation, real appreciation, and the holding period.
- ^{2/} All capital includes equipment, structures and inventories.
- ^{3/} Assumes LIFO accounting with no reduction in inventories and inventory prices rising with the general price level.
- ^{4/} Assumes 46 percent corporate statutory tax rate and 45 percent personal tax rate under current law. Assumes sum of years digits depreciation over 9 years and 10 percent investment credit for equipment and 150 percent declining balance over a 34.4 year average life for structures.
- ^{5/} Assumes 46 percent corporate tax rate and 45 percent personal tax rate. Assumes 5-year depreciation schedule with half-basis adjustment for equipment and 18-year schedule for structures.
- ^{6/} Assumes 33 percent corporate rate and 35 percent personal rate under reform. Tax depreciation rates assumed equal to economic depreciation rates. Deviations may slightly alter tax rates.
- ^{7/} Effective tax rates are overstated. In a revenue neutral proposal, elimination of dividend relief would imply lower statutory tax rates.
- ^{8/} Assumes 50 percent corporate deduction for net dividends paid.

assume that the first goods put into inventory are the first ones out (FIFO), or they can assume that the last goods in are the first ones out (LIFO). Roughly 95 percent of firms with inventories use FIFO accounting for tax purposes. In an inflationary period the use of FIFO overstates current taxable income, because the deduction for cost of goods sold is based on lower prices that prevailed earlier. Nonetheless, many firms are dissuaded from switching to LIFO by, among other considerations, the "LIFO conformity requirement," which specifies that if LIFO is used for tax purposes it also must also be used for financial accounting. The overstatement of taxable income that results from the use of FIFO under inflationary conditions implies that the tax system imposes a penalty on inventory-intensive activities.

The important role of inventories in the economy is often overlooked. Inventories account for approximately one-fifth of corporate non-financial assets, and more than one-third of corporate depreciable assets. For many types of industries, particularly the wholesale and retail trade and service industries, inventories are more important than depreciable assets. (See Table 6-6.) Thus, in a system which indexes depreciation allowances and capital gains, indexing inventories is essential for economic neutrality across types of business assets and across industries.

The Treasury Department suggests repeal of the LIFO conformity requirement since it induces many firms to use accounting practices in calculating taxable income that seriously mismeasure income during inflationary periods; it is an anachronism that has no counterpart in other parts of the tax law.

In addition, the Treasury Department proposes that firms be given the option of employing indexed FIFO, instead of either LIFO or unindexed FIFO. Under indexed FIFO, the value of all goods in inventory will be adjusted (written up or down) for the amount of inflation that has occurred since their acquisition. Thus, since inflationary gains are permanently removed from the tax base, indexed FIFO measures income more accurately than does LIFO, where inflationary gains are only deferred until the firm reduces its inventory or liquidates. Also, indexed FIFO is thought to be somewhat simpler than LIFO. Adoption of indexed FIFO will not be mandatory, however.

D. Indexing Interest

Nominal interest rates include an inflation premium that compensates lenders for the loss of principal. Under current law, interest income and expense are overstated during a time of inflation, since nominal interest receipts are fully taxable and nominal interest payments are fully deductible. As a result, interest income is over-taxed during an inflationary period, and saving is discouraged; similarly, borrowing and debt finance are encouraged. A completely inflation-adjusted tax system would exclude the inflationary component of nominal interest rates from taxation.

Table 6-5

Effective Corporate Income Tax Rates
 —Returns to Capital Distributed Equally Between Dividends and Capital Gains— 1/

	<u>All Capital</u> ^{2/}	<u>Equipment and Structures</u>	<u>Equipment</u>	<u>Structures</u>	<u>Inventories</u> ^{3/}
Pre-1981 law <u>4/</u>					
at 10 percent inflation	48	48	31	53	46
ACRS <u>5/</u>					
With investment tax credit					
at 10 percent inflation	41	39	20	45	46
at 5 percent inflation	35	31	-4	39	46
Without investment tax credit					
at 5 percent inflation	41	39	41	39	46
Real economic depreciation <u>6/</u>					
Without dividend relief <u>7/</u>	33	33	33	33	33
With dividend relief <u>8/</u>	27	27	27	27	27

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See Footnotes for Table 6-4.

Table 6-6

Inventories as Percent of Total Physical Assets and Depreciable Assets

Industry	Inventories as Percent of Total:	
	Physical Assets 1/	Net Depreciable Assets
Agriculture	14.3 %	31.7%
Mining	9.1	18.1
Construction	34.8	87.5
Manufacturing	29.2	54.3
Transportation	5.1	5.6
Wholesale Trade	61.2	216.5
Retail Trade	50.9	135.3
Finance, Real Estate	3.8	11.7
Services	10.1	14.5
Total	22.4%	39.3%

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1/ Physical assets include inventories, net depreciable, depletable, and intangible assets, land and other non-financial assets.

Source: 1981 Statistics of Income Corporate Income Tax Returns.

Perfect adjustment of debt or interest for inflation would require that lenders receive an annual deduction for each outstanding loan equal to the product of the inflation rate and the principal of the loan; borrowers would report an offsetting amount of taxable income on each loan. Such an approach would be extremely complicated, and thus is not recommended. The Treasury Department does, however, propose a rough surrogate for an exact inflation adjustment. Under this proposal a given fraction of interest income will be excluded from tax, and the deduction of interest expense (in excess of the sum of mortgage interest attributable to the principal residence of an individual taxpayer and \$5,000) will be reduced by the same fraction. Corporations will also exclude this fraction of interest income or expense.

The fraction of interest income and expense to be excluded will be set to reflect the approximate relationship between the current inflation rate and the long-run real interest rate. In an ideal world, the exclusion rate that would result in accurate measurement of real interest income and expense would equal the ratio of the inflation rate to the nominal rate. This relationship was used in calculating Table 6-7, which provides the proposed relationship between inflation and the exclusion rate; these results are based on the conservative assumption of a 6 percent real interest rate (a lower real interest rate would result in higher exclusion rates). The exclusion rate to be used in calculating interest income and expense will be announced each year. Inflation will be measured by the percentage increase in the consumer price index (CPI) over the previous twelve months. If, for example, the CPI increases by 4 percent, 40 percent of nominal net interest income will not be taxed.

The proposed approach provides only a rough adjustment for inflation. Although the inflation adjustment will not be exact most of the time, it will clearly be more appropriate than the zero-inflation assumption implicit in the current law's treatment of all nominal interest as taxable income or deductible expense.

As long as neither interest receipts nor interest payments are indexed, lenders will be taxed too heavily and borrowers too lightly. This tax treatment accentuates the incentive under the current progressive rate structure for low-bracket taxpayers to acquire interest-bearing assets and avoid borrowing, while high-bracket taxpayers borrow and avoid interest-bearing assets. Moreover, these undesirable distortions of behavior would be accentuated if depreciation deductions and capital gains are indexed but interest receipts and payments are not. Investors in high tax brackets would have a strong incentive to out-bid other investors for borrowed funds in order to finance the acquisition of depreciable assets and assets expected to yield indexed capital gains. These incentives will be mitigated under a system with fractional exclusion of interest receipts and expenses. As a result, high-bracket investors will have less incentive to borrow and a stronger incentive to equity-finance their acquisition of assets. In addition, interest indexing will

Table 6-7
Fractional Exclusion Rate Table

Constant Real Before Tax Rate of Return of 6 Percent

Inflation Rate (%)	:	Nominal Interest Rate (%)	:	Optimal Exclusion Rate (%)
0		6		0
1		7		14
2		8		25
3		9		33
4		10		40
5		11		45
6		12		50
7		13		54
8		14		57
9		15		60
10		16		62
11		17		65
12		18		67

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reduce the tax disadvantage of taxable debt relative to tax-exempt bonds. This in turn will make it easier and cheaper for other investors to obtain borrowed funds.

IV. Retirement Savings

By encouraging taxpayers to save for retirement, the tax-preferred treatment of retirement plans serves two important public purposes. It helps retirees accumulate funds so they can live out their lives in dignity without becoming wards of society, and it produces saving that can be made available for capital formation. In the latter sense, tax-preferred retirement plans have much the same benefits as a consumed income tax, but without its other disadvantages (discussed more fully in chapter 9). The Treasury Department believes that the present tax incentives for such retirement plans should be retained but made more consistent. The retirement saving proposals should increase saving, provide greater protection for spouses, and simplify compliance and administration.

Under current law, individual retirement plans (IRAs) are fully available only to those who are employed. Whereas an employee can contribute up to \$2,000 per year tax-free on his or her own behalf, only an additional \$250 can be contributed to a "spousal" IRA. The Treasury Department supports the Administration's proposal that IRAs be available on equal terms to spouses working in the home and in the market. Further, the Treasury Department proposes that the limits on an IRA be raised to \$2,500 for both employees and those working at home, that is, to \$5,000 for husband and wife. With the present limits, over one-half of tax returns with payments to IRAs showed maximum contributions; thus the availability of IRAs provided little incentive at the margin for additional saving. Increasing the limits will make this general saving incentive more effective.

Employees of employers that maintain qualified cash or deferred arrangements (401(k) plans) effectively can avoid the IRA limitations of current law by making additional deductible contributions to these plans. The Treasury Department believes that this disparity among individuals is inappropriate and thus, coupled with increasing the limits on IRAs, proposes to repeal the current provisions that accord cash or deferred arrangements preferential tax treatment. Employers will be able to set up IRA plans for their employees, as under current law.

• Other revisions are required to provide consistent treatment of various types of retirement plans. Under current law the tax treatment of both contributions to retirement plans and subsequent distributions may be different, depending upon the particular type of plan. The Treasury Department proposes to establish a consistent and uniform policy that will apply to all retirement plans. Certain early distributions to finance first-time purchases of homes and college education will be subject to a 10 percent tax; the tax will be raised to 20 percent for other early distributions.

Current law contains annual limits on contributions and benefits that may be provided to an individual under an employer's tax-favored retirement plans. There are separate rules limiting contributions to two types of pension plans, those where a fixed contribution is required (defined contribution plans) and those that promise a fixed benefit (defined benefit plans). The defined contribution plan dollar limit, at \$30,000 per year, is much more generous than the defined benefit limit, which allows deductions to finance future benefits of up to \$90,000 per year. In addition, complex rules are required to limit contributions and benefits on behalf of employees who participate in both types of plans.

The Treasury Department proposes to eliminate the overall limit for individuals participating in both defined contribution and defined benefit plans that provide significant benefits to rank-and-file employees. To replace the overall limit, and to limit the ability of an individual to accrue excessive benefits by working for separate employers, the Treasury Department proposes to apply an excise tax on extraordinary withdrawals made in any year from either type of plan. This and more specific reforms will both simplify considerably the task of employers who must deal with the present complex rules and provide greater rationality and consistency in this area.

V. Neutrality Toward the Form of Business Organization

Under present law, equity income originating in the corporate sector is taxed twice -- first as corporate profits and then as dividends. This double taxation of dividends, coupled with the deductibility of interest payments, discourages the use of equity finance and favors debt finance. Double taxation of dividends also discourages saving and discriminates against investment in the corporate sector. By comparison, opportunities for tax shelters, the benefits of which are usually most easily available through partnerships, artificially encourage the use of that form of business organization.

Between 1963 and 1982 the value of all partnership assets increased almost twelve-fold, from an estimated \$71.8 billion in 1963 to \$845 billion in 1982. Assets owned by partnerships in the two most important and popular tax shelter industries, oil and gas drilling and real estate, grew even more rapidly, increasing roughly sixteen-fold during the same period. By comparison, between 1963 and 1982 the value of corporate assets increased slightly more than six-fold, from \$1.48 trillion to \$9.1 trillion.

The Treasury Department proposes several fundamental changes that will foster neutrality in the selection of organizational form, and in the choice among alternative methods of finance. Without these changes, both corporations and partnerships would continue to rely too heavily on debt finance, the recent tax-induced shift of assets away from the corporate sector would continue, and tax administration would be needlessly difficult.

A. Relief for Double Taxation of Dividends

With a comprehensive corporate income tax base, income derived from equity investment in the corporate sector would be taxed twice -- once when earned by a corporation and again when distributed to shareholders. The double taxation of dividends has several undesirable effects. It encourages corporations to rely too heavily on debt rather than equity finance. By increasing the risk of bankruptcy, this artificial inducement for debt finance increases the incidence of bankruptcies during business downturns.

The double taxation of dividends also creates an inducement for firms to retain earnings, rather than pay them out as dividends. There is, however, no reason to believe that firms with retained earnings are necessarily those with the best investment opportunities. Instead, they may have more funds than they can invest productively, while new enterprises lack capital. If retained earnings are used to finance relatively low productivity investments, including uneconomic acquisitions of other firms, the quality of investment suffers. In addition, both corporate investment and aggregate saving are discouraged, because the double taxation of dividends increases the cost of capital to corporations and reduces the return to individual investors.

These problems cannot be solved by simply eliminating the corporate income tax. If there were no corporate tax, dividends would be taxed properly, at the tax rates of the shareholders who receive them, but earnings retained by corporations would not be taxed until distributed, and thus would be allowed to accumulate tax-free. As a result, there would be a substantial incentive to conduct business in corporate form, in order to take advantage of these benefits of tax exemption and deferral.

Nor can the corporate and individual income taxes be fully integrated by treating the corporation as a partnership for tax purposes. Technical difficulties such as those described below preclude adoption of this approach. The Treasury Department thus proposes that the United States, following the practice of many other developed countries, continue to levy the corporate income tax on earnings that are retained, but provide partial relief from double taxation of dividends.

There are two alternative ways to provide dividend relief. The approach more commonly employed in other countries is to allow shareholders a credit for a portion of the corporate tax attributable to the dividends they receive. The credit is generally available only to residents, although it is sometimes extended to foreigners by treaty. The credit can be denied tax-exempt organizations, if that is desired.

The simpler method, and the one proposed by the Treasury Department, will allow corporations a deduction for dividends paid similar to the deduction for interest expense. Dividends paid to

nonresident shareholders will be subject to a compensatory withholding tax, equivalent to the reduction in tax at the corporate level. The proposal will not impose such a compensatory tax where it would be contrary to a U.S. tax treaty; nor will the compensatory tax apply to dividends paid to U.S. tax-exempt organizations. However, the initial decision to extend the benefits of dividend relief to these two groups of shareholders will be subject to continuing review.

Despite the advantages of full relief from double taxation of dividends, the Treasury Department proposal would provide a deduction of only one-half of dividends paid from income taxed to the corporation. This decision is based primarily on considerations of revenue loss, and can be reconsidered once the proposal is fully phased in.

The deduction will not be allowed for dividends paid from income that had not been subject to corporate tax; firms wishing to pay out tax-preferred income will not receive a deduction, but dividends will be presumed to be paid first from fully taxed income. For this purpose, income that did not bear a corporate tax because of allowable credits, including foreign tax credits, will not be eligible for the deduction.

Reduction of the double taxation of corporate equity income will tend to increase initially the market value of existing corporate shares of companies that distribute an above-average proportion of current earnings as dividends. It will reduce the current tax bias against equity finance in the corporate sector and make equity securities more competitive with debt. Because dividend relief will also reduce the tax bias against distributing earnings, corporations will be likely to pay greater dividends and to seek new funds in financial markets. Corporations will therefore, be more subject to the discipline of the marketplace and less likely to make relatively unproductive investments simply because they have available funds. Similarly, the pool of funds available to new firms with relatively high productivity investment opportunities will be larger. As a result, the productivity of investment should be improved substantially.

Dividend relief will be phased in gradually in order to match the phase-in of the correct rules for measurement of corporate income and to minimize unjustified windfall profits to current shareholders. Moreover, phasing in dividend relief will prevent a large loss of tax revenue and any associated reduction in the tax burden of high-income shareholders.

The current exclusion from individual income taxation of \$100 of dividends received serves no useful purpose and will be repealed immediately. It loses considerable revenue without stimulating significant investment in corporate equities. It would have no justification in a system that allows dividend relief.

B. Tax Treatment of Large Partnerships

Large modern partnerships have many of the attributes commonly associated with corporations, especially when there is limited liability for most partners in the enterprise. The interests in some large partnerships are even traded on organized stock exchanges. Yet partnerships still benefit from preferential tax treatment that was more fitting in a simpler world in which partnerships were typically comprised of small groups of individuals, each of whom was responsible for the liabilities of the business.

The main tax advantage of the partnership form is that gains, losses and tax credits pass through to partners, rather than being taxed to the entity. Thus, unlike corporations who cannot benefit fully from tax credits, deductions for recovery of capital costs, and interest expense if taxable income becomes negative, partnerships are able to pass any net operating losses through to partners, who can use the losses to shelter other income from tax. As a result, partnerships are an attractive vehicle for investment in tax shelter activities that initially may produce positive cash flow but result in losses for tax purposes; once the venture begins to show a profit for tax purposes, it is converted to corporate form or is sold so that deferred income is realized as tax-preferred long-term capital gains. Moreover, since debt finance magnifies the benefits of tax preferences, the tax Code encourages partnerships, as well as corporations, to rely too heavily on debt finance.

Until the mid-1960s, the corporate form of ownership was often considered the optimal way in which to hold large aggregations of assets. The corporation presented the advantages of both limited liability and a simple administrative vehicle for business transactions when large numbers of owners were involved. Because of the recent shift to the use of partnerships as tax shelters, however, ownership of more and more assets has been switched to partnership form. In many cases, the assets are actually transferred from corporations, while in other cases, new businesses that normally would be formed as corporations are now established as partnerships.

Pass-through treatment of large limited partnerships creates enormous administrative and compliance burdens for the Internal Revenue Service. Any time a partnership is audited and an adjustment is made, the tax liability of each partner must be adjusted. This process can be time consuming and expensive, as collection of additional tax can be required from hundreds of individual taxpayers, many of whom may have moved, died, or suffered substantial declines in income since the original partnership return was filed. Administrative problems such as these are among the reasons why the corporate and individual income taxes cannot be fully integrated by according corporations the pass-through treatment used for partnerships. In view of the problems encountered in applying pass-through treatment to large partnerships with many partners, it is especially appropriate to tax large partnerships as corporations where they possess important characteristics of corporations, particularly the limited liability of

partners. ' The recent proliferation of many such large partnerships suggests that the implications for tax administration of not doing so could be serious indeed.

In order to restore competitive balance between the corporate and partnership forms of business organization, and to avoid these administrative problems, the Treasury Department proposes that large limited liability partnerships be subject to taxation as corporations. Losses of such entities will not pass through to partners, earnings retained by the partnership will be subject to tax at the entity level, and distributions of partnership earnings will qualify for dividend relief. This proposal will reduce the interference of the tax law in the decision of whether to use the partnership or corporate form for ventures in which many owners are involved. Current pass-through treatment is appropriate for those corporations and partnerships that are truly mere economic extensions of their owners. Accordingly, so-called S corporations, limited partnerships with 35 or fewer limited partners, and general partnerships, including those with more than 35 partners, will continue to be accorded pass-through treatment.

The Treasury Department's proposals would promote greater neutrality in the choice of business organizational form. Additional study should be devoted to the continuing differences in the taxation of corporations and partnerships of all sizes, and of ways to make the taxation of both forms of business organization as consistent as possible. Such study also should consider the tax treatment of the trust entity and how to ensure that the use of trusts is limited to their traditional non-business functions.

APPENDIX 6-A

LIST OF PROPOSED REFORMS

BASIC TAXATION OF CAPITAL AND BUSINESS INCOME

A. Lower Corporate Tax Rates

1. Reduce maximum corporate rate to 33%.
2. Repeal graduated corporate rate structure.
3. Repeal personal holding company tax.

B. Taxing Real Economic Income

1. Index basis (cost) of assets and tax real gains as ordinary income.
2. Index depreciation for inflation and set depreciation allowances to approximate economic depreciation.
3. Repeal investment tax credit.
4. Repeal collapsible corporation rules.
5. Allow expensing of the first \$5,000 of depreciable business property, but repeal currently scheduled increases in that dollar limit.
6. Allow indexed FIFO and repeal LIFO conformity requirement.
7. Index interest receipts and payments in excess of mortgage interest plus \$5,000.

C. Retirement Savings

1. Raise IRA limits to \$2,500.
2. Make IRA's available to both employees and spouses working in the home.
3. Subject all tax-favored retirement plans to uniform distribution rules.
 - a. Subject all pre-retirement distributions from tax-favored retirement plans to a 20 percent premature distributions tax generally, (but 10 percent if used for tuition or first-home purchase).
 - b. Subject all tax-favored retirement plans to uniform minimum distribution rules.
 - c. Repeal 10-year averaging for lump-sum distributions.
 - d. Eliminate special recovery rules for qualified plan distributions.
 - e. Repeal special treatment for distributions of employer securities.

4. Simplify the deduction, contribution, and benefit limits for tax-favored retirement plans.
 - a. Repeal aggregate-based deduction limit for profit-sharing and stock bonus plans.
 - b. Subject excess contributions to a 6 percent excise tax to recapture excessive tax benefits.
 - c. Repeal combined plan limit for non-top-heavy plans.
 - d. Subject all distributions in excess of \$112,500 per year to a 10 percent excise tax.
5. Miscellaneous changes.
 - a. Extend deduction limits for tax-favored retirement plans to employee stock ownership plan and repeal the employee stock ownership plan credit.
 - b. Repeal "cash or deferred arrangements."
 - c. Subject reversions of funds from tax-favored retirement plans to employers to a 10 percent excise tax.

D. Neutrality Toward the Form of Business Organization

1. Reduce double taxation of distributed corporate earnings by allowing 50% dividends paid deduction. (Allow 50% dividends-received deduction for intercorporate dividends).
2. Repeal \$100/\$200 exclusion of dividend income.
3. Require that all limited partnerships with more than 35 limited partners be taxed as corporations.